"YOU CAN NEVER PLAN THE FUTURE BY THE PAST"[1]

The current American corporate environment looks much like a *déjà vu* from the 1980s, with sizeable corporate mergers and acquisitions flooding the news and the daily lives of investors and executives. But, if during the 1980's corporate raiders[2] and their innovative leveraging mechanisms took center stage, nowadays large activist funds holding investment theses that make even the most cost-aggressive CEO's weary, are at the forefront of the corporate environment.

These new raiders are not the formerly lesser-known characters of the last decade, who appeared almost out of nowhere trying to take over control of Corporate America, but instead are a powerful hedge fund industry with an economic and political clout hardly seen in the past. Moreover, they smartly hide behind a speech of support towards corporate governance and the interests of minority shareholders, ensuring a seal of approval from the media, which allows everything to flow more smoothly than in the past.

This industry's intrinsic leverage allows managers to invest significant amounts of third-party capital alongside a comparatively small proprietary base. The icing on the cake is the high dispersion of ownership, which further enhances the possibility of altering a company's path with a small minority position. This combination can lead to several misalignments between these hedge fund managers' interests, those of their investors and those of long-term shareholders.

In the beginning of the activist process similar characteristics are found in the companies under attack: leniency with costs, inefficient capital allocation, rich compensation packages, extensive corporate perks and a disproportionate focus of executives in maintaining a good image. At this moment, an "activism textbook" is immediately put into practice. The famous "low-hanging fruits" are picked up in the short term, and a comfortable sensation of value creation for all the shareholders ensues.

As with every financial "revolution", the gains that accrue from activism are huge in the outset of the strategy's implementation. The new technique seems able to turn lead into gold. The success of the "first alchemists" is born amid an environment of low competition, is boosted by a smart business pitch to investors, and then becomes harassed by expressive amounts of capital. This easy access to capital combined with the natural exhaustion of clear investment opportunities, adversely selects more aggressive individuals who ignore the risks being incurred. Furthermore, these individuals are less focused on generating long-term value for companies. Instead of attempting that which is feasible, they focus their expectations on the preferred outcome.

On Napoleon, expectations & bagels[3]

On the morning when Napoleon won one of his most important battles, he rallied his commanders to reward them for their courage. The General of the Bavarian troops kneeled before the Emperor and declared: "I ask for autonomy for Bavaria." The Emperor immediately replied: "So it shall be!" Next, the Slovakian General seized the opportunity and declared: "Freedom for Slovakia." Napoleon was even quicker in his response: "Freedom shall be granted to Slovakia." The last General took a step forward, and Napoleon asked: "And what of you my loyal friend? What reward do you ask for your bravery?" - "I would like to have a cup of hot coffee and two bagels with cream cheese." Napoleon ordered one of his subordinates to bring the last reward, saluted all those present and left the room. While the last General savored his meal, the others looked at him, astonished. "You are a fool!", one of them yelled, "Why did you make such a stupid request? You could have asked for nations, riches and power!" The General stopped eating for a moment and replied: "At least I got what I asked for."

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[1] Edmund Burke, conservative Irish politician and philosopher

[2] *"A person or business that attempts to take control of a corporation, against its wishes, by buying its stock and replacing its management"* (Bryan A Garner. *Black's law dictionary*, *8th Ed*. St. Paul (MN). Thomson West. 2004). The term became popular in the 1980's to describe the several hostile takeovers of the American corporate establishment by names that were unknown at the time, among whom one can highlight Carl Icahn, Victor Posner, Nelson Peltz, T. Bone Pickens and Ronald Perelman

[3] Adaptation of the tale "Two Bagels", rabbi Tuvia Bolton

The rewards of managers who act within this strategy have reached exorbitant amounts and the misalignment of interests is testing dangerous levels. At this stage, there is a clear risk that agents torture premises in an effort to fit targets that should not be pursued in a more normal state of nature, into their activist funds.

We fear that this *modus operandi*, which is hungry for immediate results, may lead to the extinction of one of the most important and rare qualities in corporate managers: the capacity to adopt hard measures with high initial costs, but which are often the vectors for the construction of a promising future. Taking things to the limit, one could assume that even the most experienced executives would be forced to work in accordance with the new *status quo* due to career risk. Ironically, the traditional agency problem (management vs. shareholders) may end up being replaced by a rearrangement of power that places two types of minority shareholders (shareholders organized around a more aggressive agenda vs. traditional minority shareholders) on opposite sides.

"HEGEL REMARKS SOMEWHERE THAT ALL GREAT, WORLD-HISTORICAL FACTS AND PERSONAGES OCCUR, AS IT WERE, TWICE. HE FORGOT TO ADD: THE FIRST TIME AS TRAGEDY, THE SECOND AS FARCE"[4]

In Brazil, the historical context behind the approximation between investment funds and corporations was vastly different from that of the United States. In the 1960's and 70's, the stock market was boosted by the wrong motivations. Instead of playing the role of being long-term financiers of companies, investors sought mainly to utilize vehicles investing in stocks as a means to benefit from a tax law which allowed a certain amount of income tax deductibility for those who invested in such vehicles[5]. Moreover, a concentrated ownership structure and a recently enacted corporate law completed the scenario of a market whose participants had speculation as their main practice.

Shyly in the 1980s, but primarily throughout the 1990s following the process of economic and monetary stabilization, stocks started to be duly treated as stakes in companies instead of just tickers on the stock exchange. Activism appears naturally in this context[6].

Initially, it appeared as a form of cooperation with the companies that went public in the prior period. This collaborative activism was marked by a *quasi*-consultative relationship between board members coming from investment funds and the executives of companies. The themes discussed were concentrated mainly on capital allocation, executive compensation, transparent communication with the market and the liquidity of stocks. Much of this work was carried out with the aim of solving the problems of a legacy of minority stakes acquired by pension funds in the previous 20 years. While this type of theme was still incipient, activism turned out to be beneficial.

Later, activism played a more defensive role. The aim was to protect minority shareholders from arbitrary changes to Brazil's corporate law (removal of the tag-along clause[7] for common stocks), which were enacted in order to maximize the control premium the government would receive during the privatization of state-owned companies. This occurred at a moment during which corporate globalization was gaining traction and the 1999 Real devaluation made our companies cheaper in foreign currency. Without tag-along rights in place and with the structural misalignment that resulted from Brazilian companies' equity-capital structure, minority shareholders were put in an extremely uncomfortable position. This structure, based on a ratio of 1/3 common stock and 2/3 preferred stock, allowed corporate owners to control their

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[4] Karl Marx

[5] In addition to the above-mentioned tax-related reasons (*Lei Fundos 157*, which could be translated roughly as "Fund's Law 157", of 1967), we must also highlight an improvement in the rules and procedures pertaining to publicly-traded companies with Law no. 6,404/76 (*Lei da Sociedade por ações*, which could be translated roughly as "the Law of publicly traded companies"), as well as the creation of CVM (Brazil's SEC) through Law no. 6,385/76, as important drivers of the IPO's that happened during this period

[6] For all purposes, we are considering solely institutional activism, and not the empire-building of specific individuals and groups which was already ongoing in Brazil

[7] In 1997, Law 9,457 revoked article 254 of Law 6,404/76, terminating the tag-along clause. It was reintroduced only in 2001 through Law 10,303, known for having fueled a small-scale reform in Brazil's corporate law

companies with a low economic interest. It was the perfect scenario for controlling shareholders to make spectacular gains benefited by the weak governance of the local market.

These two facets of Brazilian activism built interesting track records and solid reputations for the funds practicing them. It was almost as if they were practicing arbitrage between a more archaic market that had been bolstered toward controlling shareholders and what was still an embryonic idea of a market that would better represent the interests of minority shareholders. The precursors to these strategies not only generated excellent returns, but also contributed to the construction of a corporate legacy in Brazil.

The success reached by these investors boosted the independently managed Brazilian equity-funds industry. However, what was for them a localized and particular strategy, in the stage that followed became an obsession for activist contribution. Additionally, it appears to us that, the motivations of the players that appeared in this novel environment swing between the extremes of cynicism and absolute naivete.

"IF A *MALANDRO* KNEW HOW GOOD IT IS TO BE HONEST, HE WOULD BE HONEST FOR TRICKERY'S SAKE"[8]

The last decade began with several dark clouds hovering over the Brazilian capital markets. Brazilian activism had clearly been bent toward "defensiveness", while governance reached its lowest levels. It is during this time that Brazil's stock-exchange, Bovespa, in an almost heroic act, created three special tiers of corporate governance (Level 1, Level 2 and *Novo Mercado*[9]) in an effort to lure companies to a new and enhanced set of rules. Initially, without sizeable examples of potential benefits from a better governance, the membership to this new model was basically non-existent, and the proposed changes seemed innocuous. The move was similar to that of the musicians on the Titanic who kept playing their instruments even while the ship bent and sank toward the depths of the ocean.

However, the resumption of growth in Brazil amid an economically and regulatorily stable environment, combined with the beginning of a boom in the emerging economies, brought about an awakening of public offerings. The fact that a modern regulation already existed worked as a catalyst for the rebirth of the national capital markets.

The success of the listings that occurred under the new standards, led by CCR in 2002 and followed between 2004 and 2005 by names such as Natura, Dasa, Porto Seguro and Localiza, rekindled in controlling shareholders the idea that there could be value in becoming an effective partner of minority shareholders and not solely using them as a source of cheap funding. What followed was a rather positive wave of "social proof"[10], in which several corporate leaders incorporated a more cooperative stance and became committed to the new, more elevated levels of governance.

Evidently, there still remain a number of companies that insist in treating minority shareholders merely as a source of low cost capital and overlook the possibility of building a long-term, equitable relationship, with such. One shouldn't dedicate much time to these investment opportunities and should one choose to invest regardless, the non-negligible chances of incurring in a permanent loss of capital as a result of the several governance-related risks should be taken into account. Practicing "defense activism" without these caveats may prompt the investor to naively calculate unreal return premises, which can be detrimental to the decision-making process. Ultimately, the companies that have not yet been capable of noticing the structural changes that occurred in the past few years, thus not reaping the benefits of all this institutional advancement, likely have no interest in changing.

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[8] English adaptation to Brazilian folk composer and singer, Jorge Ben Jor's, famous phrase: "*Se malandro soubesse como é bom ser honesto seria honesto só por malandragem*". A *malandro* is a sort of Bohemian small-scale trickster, generally accepted by Brazilian society and treated without much reproval

[9] *Novo Mercado* means "New Market"

[10] "Social Proof" is a psychological phenomenon whereby individuals assume the actions of others as an example of correct behavior for a given situation. This concept is debated in pragmatic fashion by Charlie Munger, in a 1995 Harvard speech popularly known as "The Psychology of Human Misjudgment". For an extended transcript of this lecture, visit: http://law.indiana.edu/instruction/profession/doc/16_1.pdf

BRAZILIAN ACTIVISM, SECOND ROUND: "NEVER PUT OFF UNTIL TOMORROW WHAT YOU YOU CAN PUT OFF INDEFINITELY"[11]

In mature markets activist investors' demands evolve to more complex subjects pertaining to strategic and cultural matters. These are issues sensitive to discussion with the controlling shareholder or his executives, who naturally consider themselves specialists in these areas.

In Brazil, the concentration of control is one of the major roadblocks for funds to contribute effectively toward business strategy. This characteristic makes the position of the activists in the boardroom unbalanced and limited by a formality that only the traditional power relations possess. The individual who holds the sword has the final say. The one who doesn't, accepts his insignificance and seeks to implement changes by means of a smooth, long and far too polite manner. Applied to this new environment, the effectiveness of the prior collaborative activism becomes demanding and, most-likely, a low impact task. In order for the dialogue to be effective, it is necessary that a certain institutional rearrangement occurs.

The will to insert oneself into this profitable activist niche also makes for situations that are murky, at best. Some funds begin an attempt at becoming closer to the companies via their boards with the idea of enriching analytical capacity with the construction of new relationships. At the same time, they believe that the information "from within" will allow for an edge in the investment decision-making process. In addition to touching on ill-defined aspects of the law, this opportunism disguised as activism, appears to present a fallacious reasoning.

Firstly, flexibility is lost (capacity to "vote with one's feet"[12]) as agents become closer to a company's board of directors. One will hardly be able to utilize any informational advantage in accordance with the law, despite not everyone operating within the limits of these confinements. Even for those who do not care about legal contingencies (nor about the moral considerations involved), it must be taken into account that if it's already difficult to change an opinion after an exhaustive study on a specific asset, the entry onto the board and its eventual public exposure, further complicates everything.

Secondly, the current interaction with executives and board members is not at all transparent. The boom in public offerings and the strong appreciation of the market in the past few years raised the degree of optimism in speeches. Amid this scenario, middle management and the non-primary sources of information have become a much more reliable interface than the most important agents within companies' managements.

Undoubtedly there are situations where the benefits of acting as a collaborative board member are tangible. If the investor patiently nurtures a relationship with the executives and the boards, in an effort to contribute and at the same time learn about the nuances of the business, several "positive externalities" can be generated. For instance, Warren Buffett's role on the board of the Washington Post in the 1970's and the friendship he developed with Katharine Graham (president of the company, largest shareholder and symbol of the political and social establishment of the U.S. at the time) was without a shadow of a doubt a new step in his career as an investor. "I am a better investor because I am a businessman, and I am a better businessman because I am an investor."[13]

However, it takes many years for these benefits to mature and such relationships tend to work better after a certain amount of time. The advantages should accrue only to those with truly long interests and mandates. This arrangement appears difficult to replicate when the business' day-to-day demands halt or hamper thriftier behavior.

The Brazilian style of activism seems stuck in the past. Its practice became futile in the vast majority of cases and the degree of efficiency of its actions decreased. On the other hand, the advance toward a "libertarian activism", which imposes itself more emphatically to the *de facto* control wielded by management, as is practiced in more developed markets (especially in the Anglo-Saxon world), seems distant. As a country with Latin DNA, we incorporate cultural and

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[11] Adaptation to the phrase generally attributed to Mark Twain: "Never put off until tomorrow what you can do the day after tomorrow"
[12] Expression attributed originally to Vladimir Lenin, commenting on the desertion of Russian soldiers from the Tsar's troops in World War I: "They voted with their feet"
[13] Warren Buffett

legislative features (civil law vs. common law practice)[14] that make this advance toward a next stage of activism, not only extremely challenging but close to impossible.

In addition to the difficulties imposed by historic formation, it is necessary for capital to be pulverized and for "managerial control"[15] to be in place in order for activists to flourish, fulfilling their true role as representatives of shareholder interests. Only under such circumstances can one, with a small stake, manage to influence the decision-making process of a company, presenting a counterpoint to the control wielded by management, by means of "proxy fights" or a less abrupt interaction. This instability of power among all the parties, when correctly dosed, tends to add value not only through the potential changes it brings, but also due to the fact that it removes directors of targeted companies from their comfort zones.

At the few Brazilian companies where the stock market fulfilled its true role as a long-term financier and ownership is pulverized, we have already started to notice examples of activist movements that show some amount of authoritative opposition to the *status quo*. The judgment of this more aggressive behavior will always be individualized. However, analyzing holistically, it has seemed positive. At least for now…

CAPITAL ALLOCATION AND AGNOSTICISM: "CONSISTENCY REQUIRES YOU TO BE AS IGNORANT TODAY AS YOU WERE A YEAR AGO"[16]

It is common to confuse discipline with consistency. Change is not always looked at positively. The good performance of activist funds seeking out-of-radar investments and participating intensely in the lives of companies marked the Brazilian investment-fund industry. However, seeking the previous model of success without an adequate reflection, and worst still, being hostage to the firm belief in the business pitch utilized to sell the strategy to potential investors, vastly diminishes the investment opportunities available.

In the Brazilian market, the number of listed assets is still quite small. The attempt to restrict oneself even more within this universe, be it to companies prone for activistism or to any thematic subgroup, looks like a typical case of "handcuff volunteerism"[17].

Successful investors (some of whom were pioneers of the activist strategy) with long track records, were capable of adapting and evolving in the long journey of compounding capital without losing their principles. They had enough intellectual honesty to admit changes to paths that seemed to lead, without obstacles, to the pot of gold. They were skillful to defeat inertia, taking the difficult first-step toward a new direction.

Maybe the secret is the humility shown by the last General in the Napoleonic tale. The temptation is to fight large battles and wait for significant rewards. But perhaps the right path is to learn how to manage expectations and seek what is reachable. After all, better a bagel in the hand than "two kingdoms in the bush"[18].

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[14] Rafael LaPorta, Florencio Lopez-de-Silanis and Andrei Shleifer. *Corporate Ownership Around the World. The Journal of Finance, Vol. LIV, No. 2.* April 1999

[15] "Managerial control" is a characterization of situations whereby dispersion of ownership is such that the managers themselves should, for all purposes, be considered as the *de facto* controllers of a corporation, even if they are not so *de jure*, given their capacity to influence all of the business' strategic decisions

[16] Bernard Berenson, American art historian

[17] Expression coined by the U.S. investor and co-founder of OakTree, Howard Marks, to describe the attitudes of managers who stubbornly insist in placing themselves in situations of institutional obligation toward flawed strategies. The concept is presented in a letter to investors in the following way: "What's the reason for this seeming inconsistency between thoughts and actions? The answer is simple. These people aren't buying because they want to, but because they feel they have to. In the past I've referred to them as 'handcuff volunteers'." For more, visit: http:/www.oaktreecapital.com/MemoTree/Ditto.pdf

[18] Adaptation to the famous phrase "A bird in the hand is worth two in the bush", popularly attributed to Ancient Greek fabulist and story-teller Aesop